

## Commercial and Industrial Loans

Consider the following procedures at each examination. Examiners are encouraged to exclude items deemed unnecessary. This procedural analysis does not represent every possible action to be taken during an examination. The references are not intended to be all-inclusive and additional guidance may exist. Many of these procedures will address more than one of the Standards and Associated Risks. For the examination process to be successful, examiners must maintain open communication with bank management and discuss relevant concerns as they arise.

**Commercial and industrial lending covers a wide range of industries and requires varying analyses in order to ascertain credit quality. In general terms, these loans can be divided into three distinct types of financing: seasonal loans, term loans, and asset-based loans. This reference is intended to give examiners an overview of the basic policy and portfolio considerations necessary to evaluate a bank's commercial and industrial lending activities. Guidance regarding specific industries can be found in various banking publications such as those made available by Robert Morris Associates.**

**Common types of commercial and industrial loans are presented below:**

**Seasonal loans are short-term obligations that generally fund increases in accounts receivable and inventory. The accounts receivable and inventory are eventually liquidated, and the bank is repaid. Loan proceeds can also fund expenses of a service company until accounts receivable are created and collected.**

**Term loans are repaid over a period longer than one year, or longer than the normal operating cycle of the borrowing entity. Most often, term loan proceeds are used to purchase fixed assets. However, term loans may also be used to convert a permanent working capital loan with no repayment understanding to a structured repayment, to finance an acquisition or change in ownership, or to arrange orderly repayment of a seasonal line that was not paid out at the bottom of the operating cycle.**

**Asset-based loans (also referred to as accounts receivable and inventory financing, or revolving credit lines) are advances that are based upon a borrowing base (percent of eligible accounts receivable and inventory, and discounted value of machinery and equipment). This form of financing differs from seasonal financing, which may also attach receivables and inventory, in that lending controls are more aggressive. See 'Asset-Based Loans' starting with question 6 for a more detailed analysis of this unique form of financing.**

### SEASONAL AND TERM LOANS

#### *Policy Considerations*

1 Determine if the loan policy adequately addresses the following commercial and industrial lending considerations given the size and complexity of the portfolio.

- 1 A Commercial and industrial loan types that the bank is willing to extend.
- 1 B Minimum guidelines for underwriting and ongoing credit analysis.

### Administration

2 Review the bank's loan approval process.

- 2 A Determine if loan presentations include an adequate analysis of the following items:  
(Note: Some of the following items may not be necessary for smaller, less-complex loans.)

- 2 A1 1. Loan purpose.
    2. Repayment source(s).
    3. Collateral.
    4. Background of borrower.
    5. Principals and management.
    6. Financial information including balance sheet, income statement, etc.
    7. Financial projections.
    8. Industry and economic outlooks.
    9. Cash flows.
    10. Borrowing and deposit history.
    11. Loan structure and terms.
    12. Loan covenants.
  - 2 B Determine whether the proper level of approval authority has been documented.
  - 2 C Determine if loan commitment letters include the same terms and conditions that were approved.
- 3 Review and assess the bank's procedures for monitoring and evaluating collateral.
  - 3 A Determine if the bank initially, and routinely thereafter, performs or obtains the following items as appropriate:
    - 3 A1 1. Verifications and inspections.
    2. Lien and litigation ("lis pendens") searches.
    3. Collateral descriptions.
    4. Accounts receivable agings, which are reviewed for trends, concentrations, ineligible accounts (intercompany transactions, receivables from foreign transactions, etc.), and compliance with formula borrowing base.
    5. Inventory schedules that identify work in process, obsolete, and ineligible inventory.
    6. Current equipment listings and evaluations.
    7. Frequent repricing of liquid or readily-marketable collateral.
    8. Valuation of intangible assets. Assessment methods include: discounted current value of cash flows; multiples of net income, commissions, and sales; comparability of recent sales or franchise values; and independent appraisals.
  - 3 B Review the bank's lien perfection procedures.
    - 3 B1 1. UCC filings.
    2. Recorded mortgages.
    3. Recorded lien on vehicle titles (where appropriate).
    4. Possession.
    5. Acknowledgment of assignments.
    6. Ships/boats: file preferred ship mortgage with the US Coast Guard.
    7. Airplanes: file with FAA in Oklahoma City (include description of motors and avionics).
    8. Radio & TV license: file with FCC.

## Documentation

- 4 Review the loan files for the maintenance of appropriate documentation.
  - 4 A Determine whether the following loan documents are on file as appropriate:
    - 4 A1 1. Notes.

2. Borrowing authorization.
3. Verification of true legal entity (proprietorship, partnership, or corporation).
4. Collateral documents.
5. Perfection of lien inspection.
6. Guarantees.
7. Loan agreement.
8. Insurance (liability, fire, or key man).
9. Bond or stock powers.
10. Appraisals.
11. Landlord lien waiver.
12. Hypothecation agreement.
13. Subordination agreement.

## Credit Analysis

5 Determine if the bank's financial analysis is adequate in relation to the size and complexity of the debt.

5 A Determine whether the quality of the financial information submitted by borrowers is commensurate with the size and complexity of the loan.

5 B Review the financial analysis management prepared to determine the financing needs and repayment capacity of the borrower. The analysis should include appropriate financial ratios, trends, cash flow history, and projections. Some common analytical ratios are listed below:

- 5 B1 1. Current.
2. Quick.
3. Inventory turnover.
4. AR turnover.
5. AP turnover.
6. Debt service coverage ratios.
  - a.  $\text{NP} + \text{Depreciation (Amortization)} / \text{CMLTD}$ .
  - b.  $\text{EBIT} / \text{Interest Expense}$ .
  - c.  $\text{EBITDA} / (\text{Interest expense plus Lease Expense})$ .
7. Profitability ratios (including percentage change).
  - a. Gross profit margin.
  - b. Operating profit margin.
  - c. Net operating income to sales.
  - d. Net income to sales.
  - e. Net income to assets.
8. Debt/tangible net worth.
9.  $(\text{Total liabilities less subordinated debt}) / (\text{subordinated debt plus tangible NW})$ .
10. Sales/fixed assets.

5 C Assess whether the bank's review evaluates important items relating to insiders of the borrowing entity, such as salaries, fees, dividends, notes receivable, and notes payable.

5 D Determine if significant balance sheet and income statement changes are properly explained and financial statement footnotes are reviewed. Determine whether management properly identifies and reviews contingent liabilities.

5 E Determine whether borrowers' cash flow statements (source and use of funds) are evaluated.

- 5 F Review borrower tax returns, if applicable.

## Policy Considerations

### ASSET-BASED LOANS

Since these credit arrangements are frequently a substitute for equity, the loans should always be secured by the liquidation value of accounts receivable, inventory, and any other collateral. Adequate administration and ultimate collectibility of these loans requires close monitoring and continuous evaluation of the value of the collateral.

- 6 Determine if the loan policy addresses the following asset-based loan considerations:
- 6 A Personal guarantees.
  - 6 B Lender liability issues.
  - 6 C Guidelines for qualified customers.
  - 6 D Advance rates are justified by the value and marketability of underlying collateral.

## Administration

- 7 Determine whether periodic on-site audits of borrowers are performed. If so, determine if the following items are included in the analysis as appropriate:
- 7 A Shipping documents.
  - 7 B Inventory invoices.
  - 7 C Turnover of AR & AP.
  - 7 D Direct verification of AR & AP.
  - 7 E Concentrations of customers' ARs. (Poor credit quality in a concentration may warrant lower advance rates.)
  - 7 F Sales dilution resulting from merchandise returns, bad debt allowances, or uncollectible receivables.
  - 7 G Borrower's credit and collection procedures.
  - 7 H Ineligible affiliate and inter-company receivables.
  - 7 I Other possibly ineligible AR.
    - 1. Restarts (new AR issued by borrower to replace an AR that is over 90 days effectively "restarts" the invoice).
    - 2. Service (lawyers, repair work, etc. are sometimes excluded).
    - 3. Foreign (sometimes excluded because of perfection difficulties outside the US).
    - 4. Chronic delinquents.
  - 7 J Aging of AR & AP.
  - 7 K Inventory make up.
    - 1. Shelf life.
    - 2. Obsolescence.

3. High tech.
4. Work In Process (WIP) (exclude from borrowing base).

7 L Machinery and equipment listing. (Note: Specialty equipment, such as molds, are typically excluded as eligible collateral).

7 M Operational risk of the borrower. The following lists possible warning signs of increased operational risk:

- 7 M1 1. Poor bookkeeping.
2. Delinquent rent.
3. Unreasonable lease terms.
4. Delinquent payroll taxes.
5. Weak internal routine and controls, such as:
  - a. Reconciliation procedures.
  - b. Physical security.
  - c. Cash management and controls.

8 Determine if the bank establishes the following controls:

8 A Borrowing bases are tailored to each borrower.

8 B Borrowing bases are adequately monitored.

8 C The management information system is adequate for asset-based lending.

8 D Credit approval presentations contain adequate asset-based lending information.

8 E Controls over disbursements exist.

8 F Controls over borrower operating accounts (DDA) are in place.

8 G The bank takes adequate steps to ensure lien positions are not undermined by post-funding changes (for example, the filing of judgements against the borrower).